

DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

36 Letters per Year — \$75 Annually

Registered with the Securities Exchange Commission

January 29, 1971

Letter 486

FAMOUS WORDS: President Nixon to a surprised Howard K. Smith, following the President's recent TV broadcast: "I am now a Keynesian in economics."

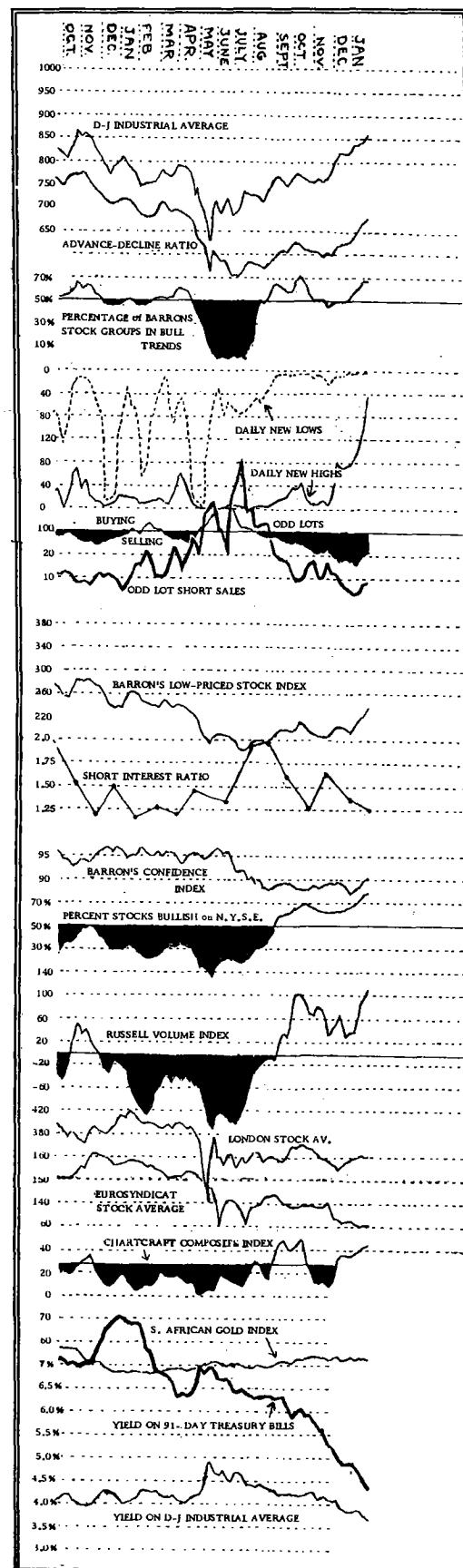
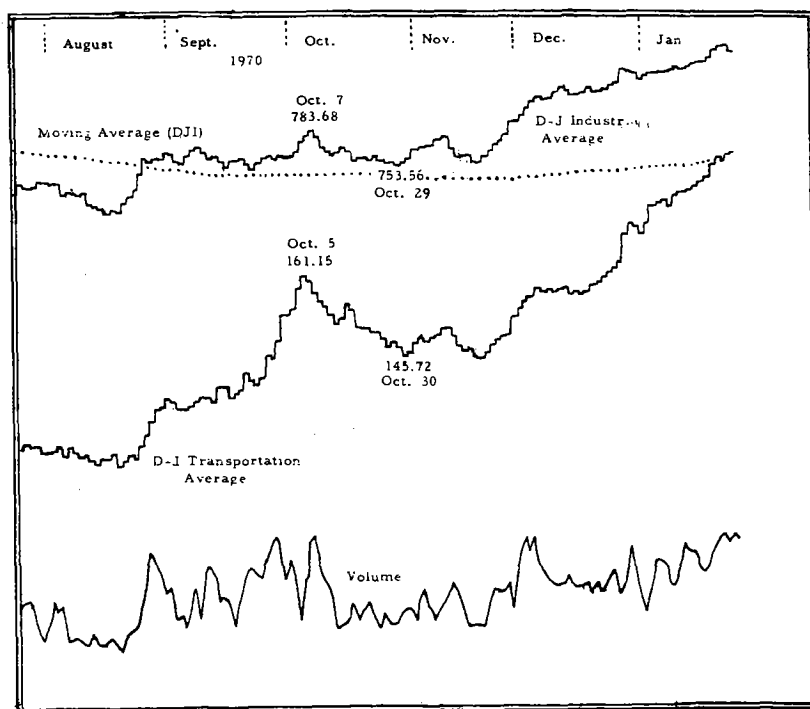
Abraham Lincoln: "We must not promise more than we ought, lest we be called upon to perform what we cannot."

Edmund Burke: "Taxing is an easy business. Any projector can contrive new impositions; any bungler can add to the old; but it is altogether wise to have no other bounds to your impositions than the patience of those who are to bear them."

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According to economist Eliot Janeway, the two big economic issues of 1971 are slated to be a Federal Sales tax to bail out the Government and a Reconstruction Finance Corp. - type organization to bail out bankrupt companies. It appears that the Federal deficit for 1971 will be around \$15 billion and the deficit for 1972 near \$25 billion. How is the Government to survive, and how are the states, counties and cities to survive? The answer, assuming it can be shoved through Congress, is more taxes, with Federal "donations" to the various states, and to sundry insolvent companies.

This is the grim prospect which faces the taxpayer over the next year or two, and there is no way of getting around it. If business remains level or even expands, the tax prospect pictured above will be the necessary one. But if business and profits turn down, the problems which will beset the nation will be so severe that nothing being talked about today will suffice. In another section of this Letter I present a chart showing how gross interest payments are slowly but relentlessly eating away at corporate profits. The chart shows why now, as never before, the nation cannot "afford" any kind of economic recession. For if a business contraction hits with any intensity, profits could well nigh disappear from the face of the land, and a crisis of unbelievable proportions would result.



Page 2 Bernard Baruch once wrote that the fantastic distress following 1929 would not have occurred if politicians would have been convinced that "two and two always equals four." If Baruch's words held true in 1929, they are doubly true today. On the last page of Letter 485 I offered a few quotes on the "infinity principle" as applied to U.S. economics.

The infinity principle has been used and believed for the past 25 years, but infinity is fast drawing to a finite close. It is taking more and more Federal Reserve credit to do less and less as the years go by, and it is estimated that it will take a much greater infusion of credit during 1971 and 1972 than it did during 1966-68, just to get the economy lifting again.

Where is the money coming from? A good deal of it must come from taxing and borrowing, neither one of which is going to help the money markets, business or the consumer. The January 21 lead-off article in the Wall Street Journal examined the reluctant car buyer, and the story is that the consumer is going to "make do" with what he has. With higher car prices and unemployment all around him the average man who used to trade his car in every two or three years is going to wait it out. The interruption of the "auto-cycle" is underway, and the pressure is already on the car dealers and the auto companies.

Yet the Government, banking all on a "let it rip" policy, is doing everything in its power to convince the man-in-the-street that everything is all right, and that a new boom is coming. So far, the boom is all on paper and in the heads of Government-paid economists. But boom it must, and boom it better if corporations are not to be subject to a new liquidity squeeze and a new, savage attack on profits via inflation and higher expenses of all kinds.

All this, the market must gauge as it moves into 1971. Now a very strange phenomenon seems to be occurring in the market much as in the economy. Two weeks ago it was reported that the inventory-sales ratio or the ratio of total business inventories to total sales rose to 1.63, the highest level in twelve years. In other words, industry is piling up goods while sales decline. Obviously, in the near future either sales must rise to cut into those inventories, or inventories (and therefore production) must be slashed in order to get inventories into line with actual sales. Of course, much depends on the consumer. If the consumer remains tight-fisted and pessimistic, sales will continue sluggish, and manufacturers will find themselves with goods "coming out of their ears."

This entire situation has been reflected very clearly in the dramatic drop in interest rates. Most people are under the illusion that the Fed itself has driven interest rates down, but in fact, the Fed has actually been following the prime rate down, dropping the discount rate after the numerous prime rate reductions. Since the middle of 1970 industrial and commercial loans (see last Letter) in leading New York banks have dropped \$2.2 billion, against a rise of \$1.4 billion the year before. Even after the GM strike this decline in loans is continuing. So if you think the Fed has manipulated the interest rates to lower levels, I suggest that you re-think the situation. Soft business and a collapse in loan demand has been the mover of interest rates to lower levels.

Now the remarkable thing is that something very similar to the economic situation is occurring on Wall Street. On Wall Street, the public can be likened to the consumer, the fellow who takes the stock inventory off the hands of the professionals. I am indebted to the Holt Investment Advisory for noting that total loans extended by the leading commercial banks to stock brokers jumped sharply in the final weeks of 1970. This would ordinarily imply a sharp rise in customers' margin accounts (where much of the money loaned to brokers goes). This was not the case however, for also Holt noted that customers' margin debt rose only 1/4 of 1% in December. So the question is — where did the 31% rise in brokers' loans go?

The answer is that it went to finance speculation by the brokers and dealers, not to their customers' margin accounts. Like industry, the brokers and dealers are now loaded with inventory (stock inventory), and they are waiting for Main Street to come in and buy.

On top of this Alan Abelson in Barron's (Jan. 25) writes that in December the mutual funds' cash as a percentage of total assets dropped to 7.6% from 9.1% the month before. This 7.6% represents the lowest level since the 7.2% of January, 1969 (just prior to the great collapse). Have the brokers, dealers and funds loaded up in this reaction in a primary bear market in expectation that the public will rush in eagerly and take the stock off their hands? It would seem so, and there is no one to say that they might not be correct. However, I am saying that if they have guessed wrong, if they failed to gauge the sentiment of the public as this bear market unfolds, then we could be in for what might be termed "a rich man's panic" as the professionals are forced to dump billions of dollars worth of stock which a pessimistic public wants no part of.

As to the stock market itself, it is worth calling attention to a statistic I went into in detail in the last Letter, the stock-bond ratio. The January 25th issue of Barron's shows that the ratio was 1.15 for the week (as against a 1929 high of 1.09 and a previous all-time high in late-December, 1968 of 1.14). The ratio is saying that stocks are now more overvalued, compared with bonds, than at any time in history (and this, despite the rally in the bond market).

In the face of the incredible stock-bond ratio statistic, Friday (January 22) saw the Dow Industrials and Transports at recovery highs accompanied by the single biggest volume day in N.Y.S.E. history (21.6 million shares). Then two days later on Wednesday (January 26) the market churned (Industrials up 1 point) on the second biggest day in Exchange history (21.3 million shares). Who are the white-hot enthusiasts here, during this bear market rally? Who is rushing in with exchange volume and the stock-bond ratio at the highest points in history? I would guess, judging from the continued heavy odd-lot selling, that the enthusiasts continue to be the brokers, the dealers and the funds. Caveat emptor.

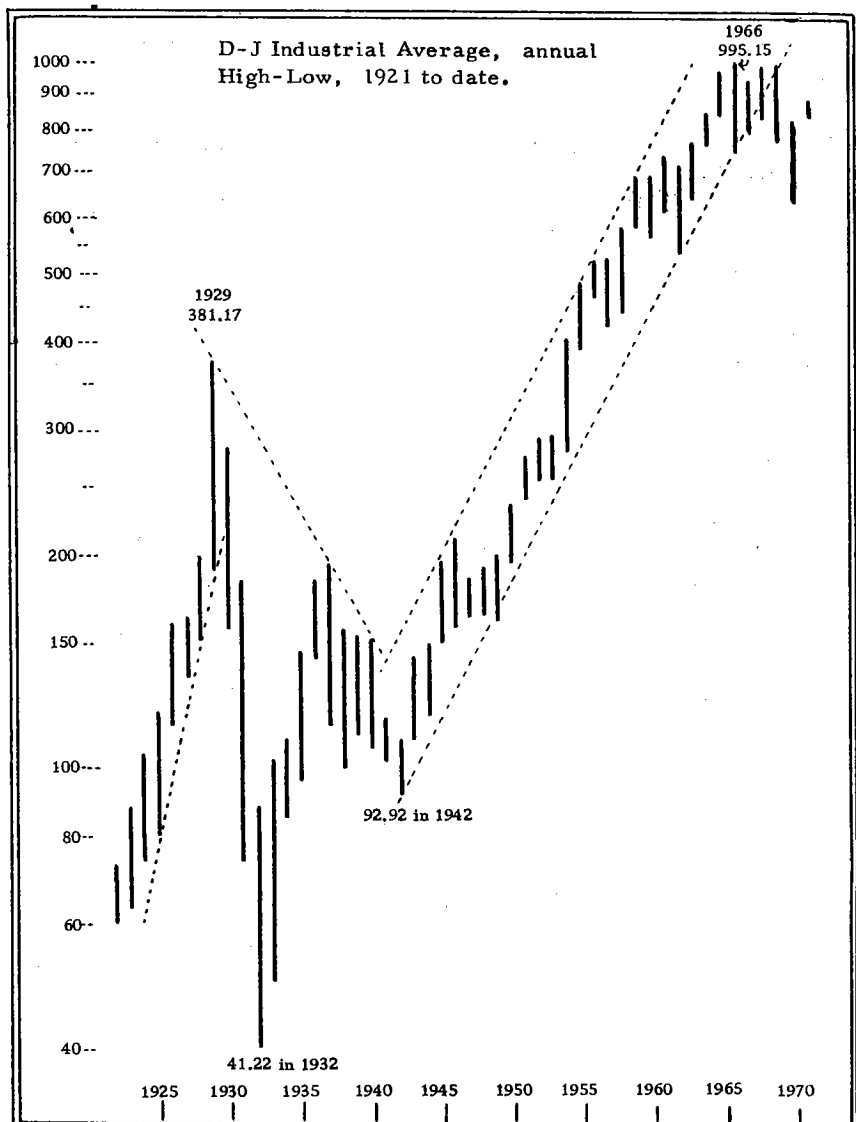
Another interesting phenomenon is the beginning of a decline in the Utility Average. That average is not confirming the new highs. Could the money-rate sensitive utility stocks be starting to discount a bottom for money rates? I think they could. If so, the bond market rally should soon peter out (as it starts to discount the avalanche of new financing ahead), and if that occurs bonds will decline, becoming increasingly competitive with common stocks as they do. It should be remembered that any bond decline from here would send the bond-stock ratio to new, unprecedented highs.

I can only say that the whole situation is both fascinating and precarious. As to readers of Dow Theory Letters, I suggest that we continue to adhere to our policy of staying in Treasury bills (80%) and gold shares (20%), while leaving the bear market "action" to the crap shooters. Our time of buying will come. And it won't come with the bond-stock ratio at a record high of 1.15.

FORTY-YEAR PERSPECTIVE:

The accompanying chart traces the annual high-low range for the Dow Industrials from 1922 to date (or through 1971 so far). This chart is a familiar one to veteran readers of these reports. Following the year 1966, I drew attention repeatedly to the 25-year rising channel formed by the Dow in its ascent from the famous 92.92 low of April, 1942.

When the bear market began in 1966, I stated that I believed that this would be a particularly vicious and extended bear market, one of the reasons being that since 1942 no major bear market had succeeded in taking the Dow Industrials below the channel lines as shown on the chart. As a rule, the longer a trend, the greater the ultimate reversal when it arrives. The reasoning is simple. Every movement in free markets is subject to correction. The longer and greater the trend in one direction, the greater the excesses built into that movement.



This rationale can be used for any free market trend, from a decline in the price of sugar to an advance in the Dow Industrials.

Note on the chart that the 1966 high-low range was followed by three successive years in which the high-low range traveled within the confines of the 1966 range. In other words, the 1967, 1968 and 1969 ranges were all held within the confines of the 1966 range. This was true even though the Dow, during 1969, broke far below the great 25-year channel for the first time since 1942. I warned that this type of "tight" formation (i. e., 1966 through 1969) usually leads to a violent move when the extreme range is broken, and since it was a bear market it was logical to believe that the range would be broken on the downside.

The break came during 1969 and 1970. The year 1970 saw the Dow well below the lower limits of the 1942-66 channel for the first time since the channel was formed. The Dow touched 631.16 in May, 1970, then reversed and embarked on a violent corrective rally. By the end of 1970 the Dow was above 800. I have shown the 1971 range, so far, and it is roughly 825-870. The 1971 range appears as practically a dot to the right of the 1970 range.

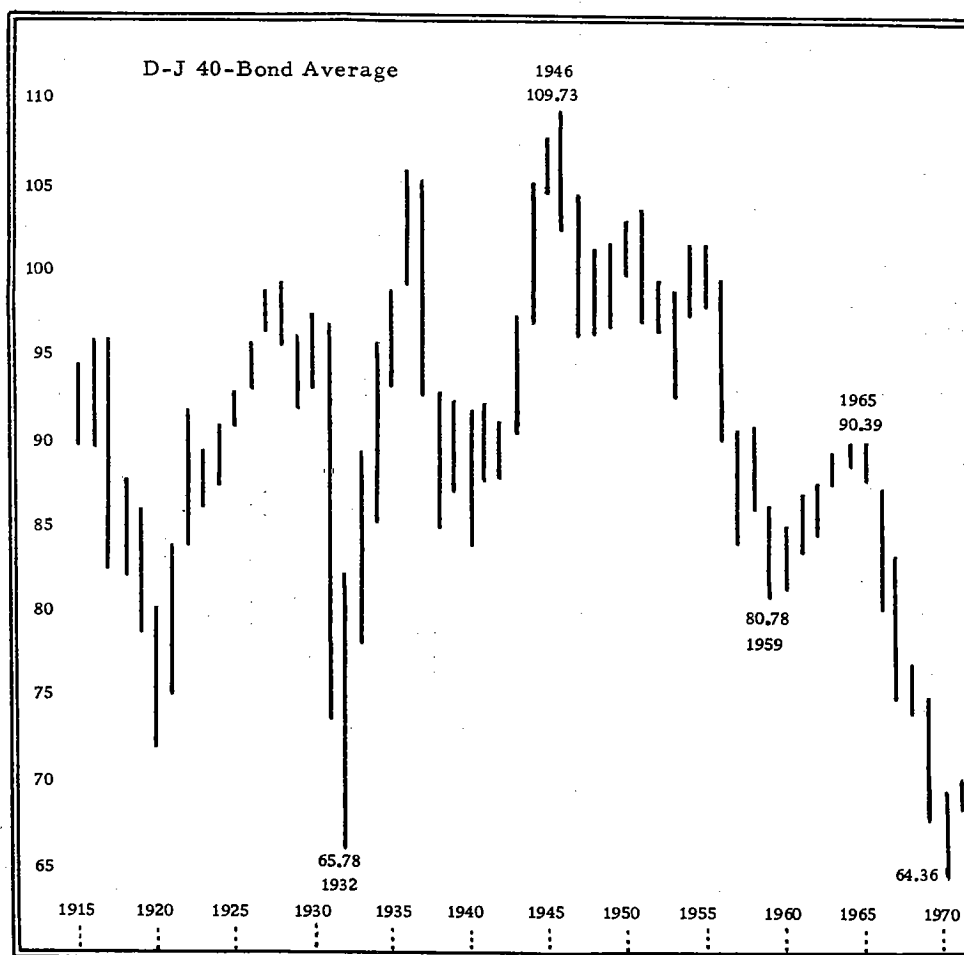
The great majority of investment advisors are now proclaiming that a new primary bull market has started. I do not agree. Study the annual chart of the Dow. Do the 1969 and 1970 downside breakouts appear to have fully corrected the great 25-year rising channel? Neither in time nor in extent does a full correction seem to have been completed.

With the impetus of a great and unending barrage of Washington propaganda, the market has been correcting the severe smash of 1969-70. But I believe that the bear market which began in 1966 still has a long way to go and a great deal of correcting to do, both in the security markets (where some correction has already taken place) and in the economy (where little or no correction of the 25 years of excesses has occurred).

BONDS AND DEBT: I am indebted to Mr. C. Coleman Petty of Louisville for the figures which went into the construction of this chart of the D-J 40-Bond Average. The chart shows the annual range of the 40-Bonds for the past 56 years, going back to 1915.

The chart shows six major bull and bear markets in bonds starting from 1915 and ending with the bull market top of 1946. During the year 1946 the 40-Bond average struck an all-time high of 109.73. That was a year after World War II, the price of bonds had been pegged by the Government, consumers had gone straight out of the Great Depression into World War II, and for 15 years (1930 to 1945) the American consumer had been dormant as far as spending was concerned. First the Depression halted his spending, then the exigencies of war made it impossible for the consumer (even though he had money) to buy what he wanted.

But in 1946 the nation embarked on the great post-war buying explosion, and as the buying increased, as fear of inflation increased, and as the country slid through economic contraction after contraction (each



January 29, 1971

one to be followed by a bigger boom), the very philosophy of buying and debt changed radically. The down-payment became the order of the land. Cars were purchased on a small "down" with three years to pay, houses were purchased on twenty and thirty year mortgages, land was purchased on miniscule down-payments, and finally the credit card became the symbol of the new way of life. And all the while the cities, the municipalities, the states and the Federal Government went deeper and deeper into debt.

In fact, deficit spending itself became an instrument of economic policy. If the nation sunk into a corrective recession, politicians used deficit spending as a means of "hyping" the economy into a new "growth" phase. But there was one growth area which was largely ignored.

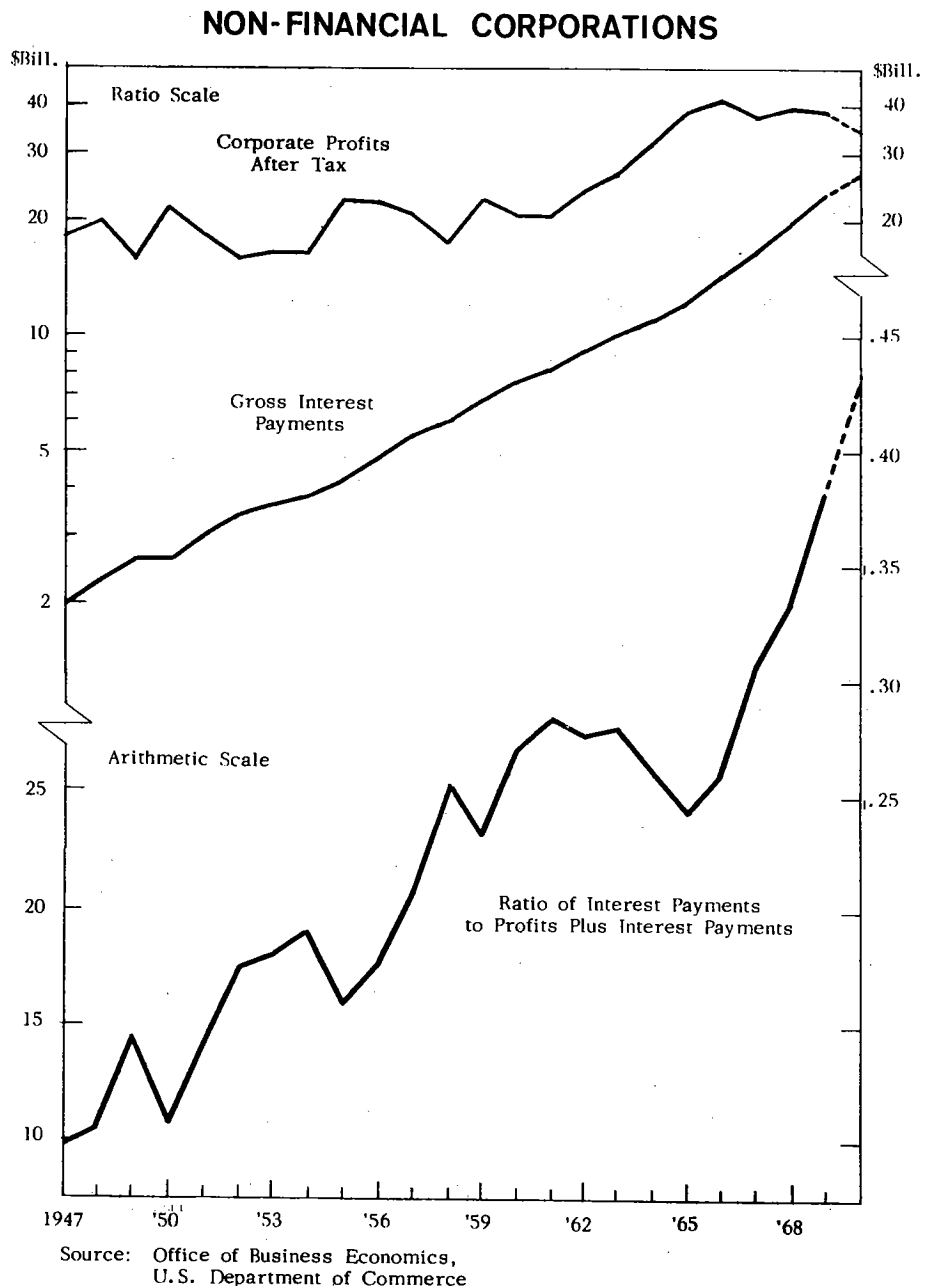
That area was the debt itself. Mr. Irving Weiss of Capital Advisors estimates that if you count all the Government, municipal, state, corporate and mortgage debt issued over the years, you come up with a total that approaches \$1.3 trillion.

Furthermore, even with the decline in interest rates during 1970-71 (and the accompanying rise in bond prices), Weiss estimates that the current loss on that debt is about \$200 million.

The chart of the 40-Bonds may help to put all this into perspective. The decline in the 40-Bond Average from the 1946 peak of 109.73 to last week's figure of 70.37 represents a loss of over one-third. Note that the 1970 low for the 40-Bonds was 64.36, incredibly below the 1932 Depression figure of 65.78. Then note that the rally from the 1964 low has taken the 40-Bond Average up about six points. That six points is equal to a recouping of about 15% of the 1946 - 1970 losses! Hardly enough to make a dent in the mountainous bond losses of the past quarter century.

The problem ahead almost boggles the mind. With \$1.3 trillion in debt outstanding, with business profits sluggish and business liquidity low, with the consumer strapped with a heavy debt load, how is this titanic debt to be serviced? To my mind, what we have now is at best a "holding action". The symbolic figure of business is getting smaller and smaller as it attempts to hold back the wall of debt which is growing larger and larger.

Perhaps this can best be illustrated in a chart which is through the courtesy of the Bank Credit Analyst (1245 Sherbrooke St. W., Montreal 109, Canada). The chart is almost self-explanatory, in that it shows the steady rise in gross interest payments on



Page 6 debt as it eats further and further into corporate profits. Obviously, if the two lines cross it will mean that payments on debt have completely devoured corporate profits, and if this occurs I believe the nation's business will face one of its worst crises in history.

The chart further points up the vital need for continued profitable business. For instance, in 1947 (where this chart begins) corporate profits could have slid considerably and still been safely above the gross interest payments line. Today, any considerable slide in corporate profits would mean that gross interest payments would run countless corporations into insolvency.

It should also be remembered that the chart takes an average of many corporations, the best included with the worst. And where the best companies may be in good shape and very solvent, hundreds of others are bringing the average down and are, in fact, extremely illiquid now. This means that there is great danger in any sustained economic contraction at this time, since it would mean a terrible squeeze on many corporate profits. It also explains why corporations today are so desperate to raise prices, as they seek to stay on the profit side of the ledger and thus keep costs from eating up the thin margin (between costs, interest payments and wages) and profits completely.

CAPITAL GOODS BOOM? This little clip shows why I am dubious of any capital goods boom during the next few years. True, the figures take into account the period of the GM strike, but they nevertheless show that the U.S. has plenty of capacity and more to handle any pick-up in business. And if business does not expand then idle capacity will rise even higher, causing many companies to give serious consideration to curtailing building and expansion plans. Finally, it is well to remember that every real business expansion since World War II has been led by a rise in capital spending. I don't see it happening today.

YIELDS: On January 26 Southwestern Bell Telephone offered for auction \$200 million of 40-year debentures. Dealers reoffered them to buyers at 101 to yield 6.80%. By the end of the day, only 10% of the new, prime Bell issue was sold. It was the first major "back-up" of a new bond issue in what, so far, has been a rising bond market.

My guess is that the march towards lower yields is drawing to a close. Within a matter of months, the bond-buying public could again be choking on a rising tide of new bond issues, and yields could be firming up and rising again. This could have the most serious consequences, both on the stock market (with the stock-bond ratio at an all-time high) and on the economy, which is depending on an ever-rising tide of new financing.

It is still too early to tell, but with the Bell issue stagnant and with the D-J Utility Average turning down, the great decline in interest rates may be drawing to a close. If it is, watch out. Rising yields, declining bonds, a sluggish economy and reticent consumers are all "muscle" in the arms of the waiting bear.

NOTE: Today I received word from Bill Gordon of New York that the Dow Short Interest ratio (see chart below) was .77 for January, 1971 as against .74 for December, 1970. The new January figure represents the fifth monthly figure under the critical 1.0 level, following the very mildly bullish 1.40 reading of August, 1970. As far as the Dow Short Interest Ratio is concerned, the Dow has been in bearish territory for five months, and the longer the ratio holds under 1.0, the more bearish the technical picture. In my mind, the bearishness is heightened since these figures have come during a technical rally in a primary bear market.

Saturday, January 23, 1971

U.S. FACTORY USE, OUTPUT OFF SHARPLY

Dow Jones News Service

WASHINGTON — Factories operated at 72.3 per cent of capacity in the fourth quarter, down sharply from the 76.2 per cent in the third quarter and the 81.7 per cent of the final period of 1969, the Federal Reserve Board reported.

It was the sixth straight quarter in which the rate trailed the previous period.

Factory output in the fourth quarter was at 159.9 per cent of the 1957-59 average, down from 166.6 in the third quarter and 172.3 in the year-earlier quarter.

Capacity rose to 222.4 per cent from 219.7 per cent in the third quarter and 211.6 per cent in the like 1969 period.

